

Key Considerations When Forming Sharia-Compliant Funds

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With the ever-expanding development and use of Sharia-compliant funds across the globe, below is a summary of some of the key issues to consider when establishing a Sharia-compliant fund.

Islamic (or “Sharia-compliant”) investing or financing is based on Islamic principles and jurisprudence (Sharia), which are derived from a number of sources, including, primarily, the Quran. These principles must be kept in mind when trying to determine the Islamic acceptability of proposed financing or investing techniques. Sharia is not a codified system of law and interpretations of the key principles can vary, particularly between the different “schools of thought.”

Key Principles

Some of the key principles of any Islamic investment or financing are the following:

- **Interest (Riba)** — no interest can be earned. Any return on money has to be earned by way of profit derived from a commercial risk taken by the banks/investment managers.
- **Unfair Enrichment/Unfair Exploitation** — contracts where one party is regarded as having unjustly gained at the expense of another are prohibited under Sharia law.
- **Speculation (Mizr)** — the contract should not rely on chance or speculation. Ordinary commercial risk-taking is acceptable, but transactions that amount to gambling will not be permitted. The key is whether something has simply been gained by chance, as opposed to an actual effort.
- **Uncertainty (Gharrar)** — there must not be uncertainty in the contract — e.g., derivatives, short-selling. The subject matter, price and time for delivery must be known at the outset of a contract.



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- **Prohibited Investments** — certain investments are prohibited, including those involving alcohol, pork, tobacco and gambling.

Note that not only the underlying investment but also the contractual terms agreed between the investors and investment manager have to be Sharia-compliant. The most common form of Sharia investment funds are equity funds and real estate funds, which would then need to employ Islamic contracts to ensure that the terms and rights of all parties are safeguarded in conformity with Islamic principles. A number of financing techniques have been developed to comply with Islamic principles, which tend to have a common reliance on physical assets as a fundamental part of the contract, since this is a classic method of addressing speculation and Riba concerns.

Practical Issues for Fund Managers and Investors in Sharia-Compliant Funds to Consider:

1. Fund Documentation

The fund documentation needs to clearly state that the fund is established for Sharia-compliant purposes and that the structure and investment of the fund will be monitored accordingly. Certain “standard” fund provisions may need to be amended to ensure Sharia compliance; for example, as investors cannot be charged interest (Riba) for late payment of commitments, an alternative mechanism would be for investors to be charged a late penalty fee, which is donated to charity.

Any fund documentation should clearly state that investors should seek their own advice as to whether or not a fund is Sharia-compliant. It should also be clear to potential investors whether or not a "Fatwa" (religious order) has been issued and if not, whether and/or when the promoters/managers intend to get a Fatwa.

2. Sharia Board

Most Islamic banks and Islamic investment funds have a religious board, which reviews proposed transactions and investments to ensure compliance with Islamic principles; this board is referred to as the “Sharia board” or committee and comprises a number of Islamic scholars. The relevant Sharia board will issue its Fatwa as a condition to any transaction or investment proceeding.

A Sharia board will need to be appointed and remunerated by the fund in order to provide guidance to the fund as to whether the fund’s structure, proposed investments and documentation are Sharia-compliant (and if so, will issue a Fatwa confirming this) and on matters of Sharia law generally. This is not a simple issue as there are relatively few well-known scholars globally and different scholars may hold different views.

3. Annual Audit

An annual audit will need to be performed to ensure ongoing compliance of the fund with Sharia principles. Although this can be undertaken by the fund’s Sharia board, it is preferable if third-party Islamic scholars do so in order to avoid any conflict of interest. This additional monitoring increases timing and cost implications for the fund.

4. Permissible Investments

The pool of assets available to a Sharia-compliant fund will normally be smaller than for a “conventional” fund, as assets for a Sharia-compliant fund must meet the criteria for Sharia compliance. The criteria apply when the investment is first made and continue to apply while the fund holds the investment.

Equity funds and real estate funds are amongst the most common investment choices.

Equity Investments

A Sharia-compliant fund must ensure that the underlying company in which it holds securities is Sharia-compliant. The fund may not invest in any company that carries on a non-Sharia-compliant activity; for example, a Sharia fund cannot invest in any businesses involved in sectors or industries such as alcohol, tobacco, pork, adult entertainment, gambling, weapons, and conventional banks or conventional derivatives. Consequently, real estate, technology, telecommunications, and oil and gas sectors are the more preferred sectors into which Sharia-compliant funds tend to invest.

As technically, the restriction on investing in companies carrying out non-Sharia-compliant activities could rule out almost every company (as most companies have at least some form of non-Sharia-compliant borrowing), Sharia scholars have developed “screening criteria” in order to help determine whether or not an investment would be Sharia-compliant. By screening stocks to ensure that they are Sharia-compliant, research costs and compliance concerns that investors would perhaps otherwise face in trying to determine whether or not an investment is Sharia-compliant can be reduced. There are some differences among the various screening methods, and the applicable Sharia board of a fund will follow the set of screening criteria that best reflects the approach of that Sharia board.

One of the most widely used set of Sharia-compliant benchmarks is the Dow Jones Islamic Market Index. To determine their eligibility for the indices, stocks are screened so that the companies meet Sharia requirements for acceptable products, business activities, debt levels, and interest income and expenses. The screening methodology is subject to input from an independent Sharia supervisory board.

Real Estate Investments

As any real estate the fund buys must be used in a Sharia-compliant manner, it is important to ensure that the property where the occupants are undertaking business activities are not those that would be non-Sharia-compliant, such as the sale of alcohol or gambling. If so, this would not be an acceptable investment for a Sharia-compliant fund.

5. Purification of Income

Income generated by a Sharia-compliant fund needs to be “purified” as it is unavoidable that some of the income generated by the underlying companies/funds in which the Sharia fund invests will include some form of non-halal income, such as interest. “Purification” essentially involves determining the amount of income attributable to non-Sharia-compliant elements and donating that amount to a charity. The Sharia board would normally be involved in determining what types of income need to be purified. The purified amounts that are then donated to charity can either be done by the fund or by the investors themselves.

6. Sharia-Compliant Leverage

A Sharia-compliant fund also needs to ensure that any leverage or financing used by the fund must be provided in a Sharia-compliant manner, which may impact both borrowing and hedging strategies that the fund may wish to undertake.

7. Standardization and Regulation of Sharia-Compliant Funds

Differences in interpretation between different schools of thought currently prevent a global set of standard documentation and regulations from being enacted that apply to Sharia-compliant funds. Although there are some industry bodies that seek to regulate which structures and products are permitted, such as the Accounting and Auditing Organisation for Islamic Financial Institutions and the Islamic Financial Services Board, a uniform set of documentation and regulations is still very much a developing area.

Fund Structures

Two of the main structures used for Sharia-compliant funds are the Mudaraba structure and the Wakala structure.

1. Mudarabah

A Mudarabah structure is an investment partnership under which the investor (the “Rab-al-Mal”) provides capital to the investment/fund manager (the “Mudarib”), who manages that capital using its professional investment skills in exchange for a fee, typically based on a share of the profits. This structure is the most common Sharia-compliant fund structure and is similar in some respects to a limited partnership.

Under a Mudarabah structure, the Mudarib is entitled to charge management and performance fees (similar to a “conventional” or non-Sharia-compliant fund structure). The investors are not involved in the day-to-day management of the fund and the liability of investors is limited to the extent of their investment. Profits are shared according to a pre-agreed ratio after investors have been paid all of their capital. The investors remain the owners of the assets and are solely responsible for losses (which are shared on a proportional basis among the investors based on their capital contributions) unless due to the Mudarib’s negligence or default.

2. Wakala

This is not as commonly used as the Mudaraba structure as, under a Wakala structure, an investor enters into a contract (“Wakala”) under which a person is appointed to act as the investor’s agent (“Wakil”). The investment manager of a Wakala will usually be considered to be the investors’ Wakil. As a Wakil, the investment manager is entitled to a predetermined fee. The Wakil acts solely as an agent, acting on the instructions of the investors.

This differs from the Mudaraba structure in that a Mudarib has the power to manage funds in accordance with its expertise. Similar to the Mudaraba structure, investors must own the fund assets or have the right to dispose of them — as the Wakil is not considered to be the owner of the assets, it is

not liable for losses except where such losses are due to its own misconduct, negligence or default.

Although there are numerous issues that have to be considered — both for the fund manager and the investors themselves — in relation to a Sharia-compliant fund that do not arise when establishing and or investing in a non-Sharia-compliant fund, the continual increase in the prevalence of these funds should ensure that not only will investors become more familiar with such funds, but that hopefully, there will begin to appear a more global set of standard documentation, regulations and guidelines, which should increase their prevalence and use even further.

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